HELP ?

Can China avert crisis?

Challenge; Armonk; Jul/Aug 2000; James Dean;

Volume: 43
Issue: 4
Start Page: 62
ISSN: 05775132

Full Text:

[Headnote]

The Asian financial crisis stoked fears in China, argues this economist. The window of opportunity to further reform has narrowed recently. China now faces dificult decisions about how to reform its state industries.

IF THE East Asian financial crisis of 1997-98 sparked One Great Debate, it was a debate over "Asian" versus "Western" capitalism. Or, more precisely, it sparked a debate about whether the root cause of the crisis was a failure of Asian capitalism or a failure of Western capitalism (Dean 2000a, 2000b). Western economists were prone to vacillate, and the most influential of them changed his mind midcrisis (Krugman 1998a, b;1999).

Had practicing the evil arts of Asian capitalism been sufficient to trigger a crisis, China should have been Asia's leading candidate for Armageddon. But China survived, while the East Asian "tigers" did not. Compared to the tigers, China was still shielded from the disciplines of global trade and finance. Admission to the World Trade Organization (WTO) will strip that shield away. This article asks whether China can survive much longer without financial turmoil, or worse. China has performed admirably It has adopted serious reforms. But its window of opportunity to make further reforms has narrowed. It remains to be seen whether the nation can still climb through.

Asian capitalism as presently practiced in China is bleeding its economy badly China's leadership has been acutely aware of this for some time--at least since the early 1990s. But the leadership has no plan for a decisive and final leap toward Western capitalism since it fears that this might trigger a profound crisis--not just economic but social and political as well. The plan instead is to "restructure" the most palpably unsustainable aspects of Asian capitalism-notably the loss-making state-owned enterprises (SOEs)--while continuing to move gradually and judiciously closer to Western capitalism.

The final destination envisaged by the Chinese Communist Party is not Western capitalism. Rather it is a state of being that the fourteenth party congress called, in October 1993, the "socialist market economy": an oxymoron that stuck and is still today very much part of official rhetoric. Nevertheless the East Asian crisis has raised more doubts than ever about the sustainability of the "socialist" part of China's emergent market economy, not least, one suspects, in the minds of many in the top ranks of the Communist Party. Put politely, the socialist market economy is a moving goalpost. Put less politely, China's policymakers are increasingly schizophrenic.1

The schizophrenia is, first, about making a final leap toward a market economy internally-in particular about privatizing the SOEs. Second, it is about embracing the market economy externally-whether or not to permit unrestricted access to foreign goods and services and unrestricted inflows and outflows of capital. Moreover, internal liberalization and external liberalization are intertwined.

In summer and early autumn of 1999, schizophrenia was just below the political surface, as China waffled about joining the WTO. Rumor had it that Prime Minister Zhu Rongji was so frustrated with his conservative colleagues, who oppose opening China further to the West, that he contemplated resigning.

For his part, President Jiang Zemin waited for President Clinton to telephone three times before returning his calls and ultimately agreeing to resume negotiations. Zhu and his liberal constituency have apparently prevailed, but the liberalization that will be mandated by the WTO poses far greater risks to financial and political stability than most Western observers appreciate.

For example, the terms of putative admission to the WTO cede greatly enhanced access to foreign banks. But all that forestalls the collapse of China's domestic banks is forbearance by Chinese depositors. If deposits move en masse to foreign banks, the SOEs will collapse too. In short, China is now more vulnerable than ever to financial crisis.2

Why Financial Crises Matter

To understand why China has thus far been willing to pay a high and rising price to avert financial crisis, I will begin by characterizing a "financial crisis" and explaining why it might be costly to the real economy A financial crisis typically involves sharp, negative, and unexpected drops in the price of financial assets, such as currencies and stocks, a sharp rise in interest rates, and often widespread bank failures.

The reason that financial crises are costly is not simply that wealthy holders of the wrong currencies, stocks, or bank shares lose money Rather it is that sharp price changes in the financial sector usually spread to the real sector. Currency, stock market, and banking crises usually lead to sharp declines in exports and in investment and consumption spending, which in turn result in sharp drops in output, incomes, and employment. Contraction in the real sector inevitably causes misery for millions of people. Consider the massive unemployment, malnutrition, and displacement of populations in Indonesia resulting from a crisis that began simply as an attack on their national currency.

Crisis in China?

In China's case, a financial crisis might evolve something like this. China's banks are kept alive only by massive indirect government subsidies.3 By continuing to keep banks alive, the Chinese government implicitly guarantees bank deposits. The average Chinese household saves about 40 percent of its annual income, and hundreds of millions of ordinary Chinese hold the bulk of their savings as bank deposits. Should the government's willingness to bail out even one Chinese bank come into doubt, or should foreign banks become an easy alternative after China joins the WTO, millions of ordinary Chinese might pull their deposits out of banks-including banks that were previously sound but would become unsound as a result. There could easily be a run on the banks.

The core business of Chinese banks is lending to the SOEs, which still produce almost 30 percent of China's national output. Most SOEs make losses rather than profits and rely on a continuing flow of new loans to stay afloat. A bank run would force a large number of SOEs to close their doors. Since two-thirds of China's city-dwellers work for SOEs, massive unemployment would ensue. And such a crisis would entail more than just unemployment, since for millions of Chinese an SOE is their only source of medical, health, housing, and education benefits.

In short, what began as a banking crisis would quickly become a massive real crisis, with severe economic and social consequences. Worst of all, the crisis could have dire political consequences, the direst of which could be popular revolt against the Communist Party's monopoly of power. The crudest interpretation of the party's willingness to pay a high price to avoid financial crisis is that it must pay that price for its very survival.

China's Triangle of Woes

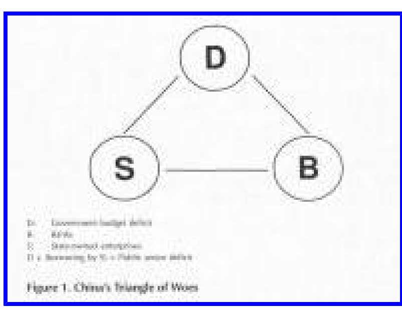
Relationships between the Chinese government, Chinese banks, and Chinese SOEs can be characterized as a "triangle of woes." Figure 1 depicts the government's fiscal deficit, D, at the top of the triangle. This feeds in to the banks, B, on the bottom right corner and then to the SOEs at S on the bottom left.

Each corner of the triangle is vulnerable to crisis on its own account. Hence crisis could erupt at the D corner if the government found itself no longer able to finance its deficit by selling bonds or printing money, at the B corner if people lost confidence in the banks and began withdrawing deposits (or even if deposits stopped growing), or at the S corner if SOE expenses finally overwhelmed cash flow from sales revenues and new borrowing.

Moreover, crises are interdependent. Crisis in any one corner could lead readily to crisis in the others. Consider a crisis originating at the apex. A crisis at D could result in the end of fiscal subsidies to banks, to SOEs, or to both. Were banks cut off from subsidies, they would likely find themselves unable to retain deposits. The crisis would have spread from D to B.4 Or if subsidies to SOEs ceased, the banks would likely find themselves hard-put to earn loan revenues, and again the fiscal crisis would spread to B. Similarly, crises in the B or S corners might spread to the D corner: If banks or SOEs were the initial source of crisis, the resulting rise in subsidy spending might so bloat the government deficit as to cause a crisis there too.

The Chinese leadership has been sensitive to this fragile symbiosis since fiscal deficits first appeared in the early 1990s. But their awareness was heightened with the onset of East Asia's crisis in mid-1997, so much so that an extraordinary meeting (a "National Financial Work Conference") was convened in Beijing on November 17,1997, to devise prophylactic measures. Its neighbors' crises threatened China both on its external trade account and on its external capital account. On the trade account, much-depreciated currencies and plummeting incomes in Southeast Asia hurt China's exports. On the capital account, foreign investment dried up, particularly from Hong Kong, China's main source of foreign investment, which was mired in its own serious recession.

The effect of China's deteriorating trade and capital accounts was an outflow of foreign exchange reserves, a decline in the monetary base, and a decline in both foreign and domestic spending on Chinese goods and services.



Enlarge 200%
Enlarge 400%

Figure 1.

Even before the decline in spending, China had been systematically overproducing goods for domestic consumption, as predictable by-products of artificially supported SOEs. When spending slowed, inventories quickly built up, output growth slowed down, and unemployment rose. Most ominously, prices began to fall. By late 1999, the East Asian crisis countries (except Indonesia) had recovered, but China's malaise has persisted. China has averted crisis, but at the price of continued slower growth and broad based deflation.

Fragile SOEs

The central economic dilemma facing China is how to phase out the loss-making SOEs without precipitating massive unemployment. The past two years' downturn in foreign and domestic spending has moved this dilemma to the top of the policy agenda. And putative admission to the WTO, which foreshadows much more foreign competition, has brought the dilemma to a head. The leadership has now moved, restructuring the SOEs to the top of its economic priorities.

"Restructuring" seems to mean turning the SOEs into profitmaking enterprises wherever possible rather than phasing them out. Ominously, it seems also to mean keeping them state-owned wherever possible rather than privatizing them. The government is keenly aware of its growing deficit and the difficulties of tax collection. It would be convenient to turn the SOEs into cash cows, but that is probably a pipe dream.

Fragile Banks The problems of the SOEs do not bode well for the banks. Hence, much of the leadership's attention, articulated best by Prime Minister Zhu, the "economic czar," has turned to the banks. Beijing bankers point out that less than 10 percent of their SOE loans are in arrears. This ignores the fact that interest payments continue to flow largely because of new loans from the very banks that collect interest on the old loans, not to mention the more direct ways in which the SOEs are subsidized.

In other words, the bulk of the banks' SOE loans are still performing only because of government guarantees on banks and government subsidies of SOEs. Were these to cease, interest payments on SOEs would cease, rendering the banks illiquid. Worse, the prospects for eventual repayment of principal would plummet, rendering the banks insolvent. Not only would the Chinese banking sector collapse were government guarantees and subsidies to end, it would collapse even if they were widely expected to end.

The only fundamental way to rescue the banks is to increase their holdings of commercially viable, performing loans. This is particularly a problem now since most commercially viable enterprises in China are joint enterprises with foreigners. But foreign direct investment (FDI) has fallen sharply since the onset of the Southeast Asian financial crisis. This leaves bankers with the challenge of finding potentially profitable indigenous investment projects.5

In reality, Chinese banks face a dearth of commercial lending opportunities.6 Consumer and household mortgage lending might offer alternative (and collateralized) opportunities, but Beijing bankers claim that convincing their customers to borrow for personal or family purposes is an uphill battle. Chinese savings habits, and the associated reluctance to borrow, are deeply ingrained.

Because of the scarcity of lending opportunities, the central bank finds it difficult to increase the money supply. It can pump cash into the banking system, but if the banks are loath to make loans, no new deposits-that is, no new money-will be created. This is the so-called pushing on a string problem: The central bank can push, but unless the so-called commercial banks pull, no new money will result.

Fragile Deficit

The reason that the Central Bank of China is trying to pump up the money supply is to generate spending. As already mentioned, China now literally suffers from deflation: Prices are falling across a wide range of consumer and other goods. Despite the "pushing on a string" problem, the Chinese money supply is increasing (at about 15 percent annually), but this is not enough to generate spending. The conventional cure for this is for the government to do the spending, since the private sector will not.

Over the past year, the Chinese have pursued what we would call "expansionary fiscal policy." Hence the growing deficit at the apex of our triangle of woes, which began as a byproduct of subsidies to the SOEs and the banks, is now growing even faster as the result of a new strategy to encourage spending?

China's Prophylactic Shield

Since China is internally fragile at each of the three corners of its triangle of woes, a crisis at any corner could quickly spread to the others. Over the past two decades, financial crises in other parts of the world have been rooted in similar fragility. Latin America's international debt crisis of 1982-89 had much to do with fiscal deficits (Bowe and Dean 1997), Mexico's crisis of 1994-- 95 had much to do with bad banking, and East Asia's crisis of 1997-98 had much to do with an unhealthy symbiosis between bad banking and loss-making enterprises.

But in each of these cases, internal fragility led to a crisis on the countries' external capital accounts, a crisis that manifested itself most dramatically as a collapse in their currencies. It was these collapsing exchange rates that led to sharp and sudden declines in real economic activity--in output and employment-- setting up a vicious circle that fed back to further currency declines, further output drops, and so on. The internal problems became a full-blown crisis with catastrophic real consequences only after they turned into external problems.

It was the sharp and sudden withdrawal of external capital that turned Southeast Asia's problems into full-blown crises. This did not happen in China. It did not happen because China was not, and is not, vulnerable to sharp withdrawals of external capital. Despite capital inflows during the 1990s that dwarfed those to any other developing country, China did not borrow as heavily relative to its foreign exchange reserves as its crisis-prone neighbors, nor did it borrow in the same form. Even though in 1997 China's external liabilities as a percentage of GDP were (and still are) higher than South Korea's, the bulk of these take the form of direct investment, mostly joint ventures, that are highly illiquid and difficult to withdraw quickly. By contrast, nearly all of Korea's external exposure was in so-called portfolio form (mostly bank debt and bonds), some two-thirds of it short term (due to be repaid fully within one year).

Nevertheless, in 1997 China did face a serious problem of capital flight. A significant percentage of export receipts was being retained abroad: Although Chinese foreign exchange controls require all export revenues to be brought home, double invoicing had become endemic. After the emergency conference convened in November 1997, measures were taken to reinforce foreign exchange controls as a shield against capital flight. The most effective measures centered on a consolidation of computer records between customs and other authorities. By some estimates, remitted export receipts in 1998 virtually doubled as a result.

This reinforcement of capital controls probably played a key role in averting a run on China's domestic currency, the renminbi (RMB). Currency inconvertibility and related capital controls are reinforced by a heavily regulated domestic financial sector that severely crimps would-be speculators who try to borrow RMB and sell short. China, unlike its crisis-prone neighbors, did not dismantle capital controls or currency inconvertibility during the 1990s, and was less prone to capital flight and currency speculation as a result.

Or Its Achilles' Heel?

China's triangle of woes would collapse in crisis if any of the three corners collapsed: if the government could no longer finance its deficit, if the customers pulled their deposits out of banks, or if the state-owned enterprises collapsed despite government subsidies or bank loans. None of this is likely to happen as long as the Communist Party keeps control. To ensure its own survival, which would be severely threatened were a financial crisis to occur, the party will continue to pour funds into the banks and the SOEs as long as necessary. And since China is a "party-state"-the Communist Party both governs and administers-were the party to collapse, the civil service would collapse with it, much as happened in post-Soviet Russia.8

The one event that could unhinge the party's best efforts to retain financial and political control is a run on the RMB. When Southeast Asia had its currency crises, this was a distinct possibility. China's exports to the region were in jeopardy, and not only did foreign investment inflows plummet, foreign firms began to leave.9 Pundits speculated that devaluation was imminent. Capital flight was endemic. Some estimates suggest that in 1997, China's entire trade surplus was matched by capital flight of the same magnitude. Although double invoicing and other loopholes in the capital controls were purportedly closed in 1998, China's "errors and omissions" entry in its balance of payments accounts show an unexplained outflow of some $18 billion. And with the recent sharp decline in inflows of new FDI, and an ominous exodus of old FDI, the capital account might turn out to be more of an Achilles heel than a prophylactic shield.

Summing Up

How did China avert the crisis that engulfed its neighbors? After all, China's "fundamentals" look far worse than Indonesia's, South Korea's, Malaysia's, or Thailand's ever did. Its state-owned enterprises and banks are insolvent if free market accounting standards are applied, and its government finances are not in superlative shape either. But China had three crisis-prevention policies in place that its neighbors did not.

First, China was, and still is, willing to pour public funds into the SOEs and the banks. Partly as a result, hundreds of millions of ordinary Chinese people are prepared to keep adding to the already massive stock of deposits in those banks, deposits that enable the banks to sustain their flow of nonrepayable loans to the SOEs. More cynically, Chinese people have nowhere else to hold their savings except as cash.10 The Southeast-Asian crisis countries, with a similarly sick symbiosis between government, banks, and industry, were unwilling to persist with loss-making subsidies. For example, it may have been Thailand's willingness to let a major bank--Finance One--fail in May 1997 that precipitated the domestic and foreign run on Thailand's banks and ultimately its currency. But China does persist.

The second policy that China had in place that her neighbors did not was capital controls. It is doubtful whether, in the crisis countries, capital controls could have been applied ex post effectively enough to stem the attacks on their currencies, given contractual obligations to repay short-term debt, although a mutually agreedupon temporary moratorium on debt repayment might well have worked. But in China's case, capital controls were already on the books, as were the will and the means to enforce them.

The third policy that shielded China from crisis was its massive foreign exchange reserves and the structure of its foreign liabilities. There was no overhang of short-term debt that could not be repaid easily out of foreign exchange reserves when debt was not rolled over. Certainly there was an exodus of direct foreign investment, but foreign assets remained in place sufficiently that foreign exchange reserves were not threatened with exhaustion.

None of this is to exonerate China's reform strategy as costless or optimal. According to Lardy (1998), direct and indirect subsidies to the SOEs and the banking system may now be costing the country some 10 percent of its GDP In the current context of declining output growth and plummeting foreign investment inflows, this strategy is unsustainable. Although WTO membership may help to restore growth and bring FDI back, it will also put unprecedented competitive pressure on the SOEs and their products.

Currency inconvertibility and capital controls are also unsustainable, especially given the mainland's porous border with Hong Kong, not to mention the pressure that WTO conditions will impose on China's financial autarky as foreign financial institutions compete for deposits. China's window of opportunity for reform and crisis aversion is still there, but it is important to recognize how much it has narrowed over the past two years.

[Footnote]
Notes

[Footnote]
1. By schizophrenic I do not mean crazy. As individuals, China's leaders are far from crazy. They simply face a dilemma that has understandably led to splits in the ranks and collective schizophrenia.

[Footnote]
2. China's agreement with the United States declares that two years after joining the WTO, foreign banks will gain substantial access to Chinese borrowers. Hence, they might be able to "cherry-pick" the better SOE loans, which would further weaken domestic banks. Then after another three years, foreign banks will be able to take general retail deposits. It is not clear at this early point how vigorously foreign banks will compete for that business, so the vision of a massive run on domestic banks may well prove excessively apocalyptic. Interestingly, within days of the WTO agreement with the United States, Chinese academics began advocating granting foreign banks quick and early joint-venture access to the state-owned domestic banks.
3. These "subsidies" take the form of interest income on government and government-guaranteed loans, as well as the continued flow of new deposits that constitute contingent liabilities of the government since the government is unlikely to allow the banks to fail.
4. Russia's financial crisis of August 1998 began this way. Russian banks were implicitly government-subsidized: They were dependent for most of their interest revenue on government bonds. When the Russian government found itself unable to raise enough tax revenue to service its own bonds, it defaulted, leaving the banks in the lurch. This in turn led to widespread losses by depositors, to a freezing up of banks' and Russia's credit lines to the West, and to a free-fall collapse in the foreign-currency value of the ruble.
5. This challenge is compounded by their almost total inexperience with the art of modern risk assessment. The authorities have moved moderately to engender this art by allowing banks for the first time to adjust their interest rates on loans within a modest band-currently between 3.2 percent and 4.8 percent with a median regulated rate of 4 percent.
6. This is not helped by legislation that threatens imprisonment for loan officers who make bad loans (although the bankers I interviewed dismissed this as a threat that has never been enforced and is likely to be idle in practice).
7. As a percentage of GDP, China's deficit is still small by international standards. But that reflects the somewhat paradoxical fact that central government spending relative to GDP is also very low-lower, in fact, than any country in the world except Nepal! China's problem is that taxes are hard to raise: Government revenue is only about 12 percent of GDP.
8. However, the long reign of the party-state in China has resulted in deeply entrenched corruption that can only be rooted out by separating party and state, and also removing the political monopoly of the Communist Party. Hence, China finds itself between a rock and a hard place. For an excellent analysis of this dilemma, see Pei (1999).
9. For example, Caterpillar, Pittsburgh Plate Glass, Foster's, and the Royal Bank of Canada have all recently pulled out of China. See Economist, September 25,1999, pp. 71-73. FDI inflows peaked in 1997 at about $45 billion. The Ministry of Foreign Trade and Economic Cooperation forecasts an inflow of $35 billion in 1999, but other estimates are as low as $17 billion (Wall Street journal, October 26, 1999).

[Footnote]
10. The pent-up demand for other outlets is evident from the popularity of "stamp markets" in major Chinese cities, where ordinary Chinese can buy limited-edition stamps for saving and speculative purposes. Pent-up demand is also evident in the

[Footnote]
sporadic frenzy surrounding trading of so-called A-shares, ownership of which is restricted to Chinese citizens.

[Reference]
For Further Reading

[Reference]
Bowe, Michael, and James W. Dean.1997. "Has the Market Solved the Sovereign Debt Crisis?" Princeton Studies in International Finance, no. 83 (August).
Dean, James W. 2000a. "Which Failed: Asian Capitalism or International Capital Markets?" In Asian Financial Crisis, vol. l of International Finance Review, ed. J. Jay Choi. JAI Press/Elsevier.
. 2000b. "East Asia Through a Glass Darkly: Disparate Lenses on the Road to Damascas." In Essays in Honor of Mark Perlman, ed.

Geoffrey Harcourt. New York: Routledge.
Krugman, Paul.1998a. "What Happened to Asia?" (web.mit.edu/krugman/January). .1998b. "Bubble, Boom, Crash: Theoretical Notes on Asia's Crisis" (web.mit. edu/krugman/January).
.1999. "Balance Sheets, the Transfer Problem, and Financial Crises" (web.mit. edu/krugman/January).
Lardy, Nicholas R. 1998. China's Unfinished Economic Revolution. Washington, DC: Brookings Institution Press.
Pei Minxin.1999. "Will China Become Another Indonesia?" Foreign Policy, no.116 (fall): 94-109.

[Reference]

Other Information Sources
China Daily, various recent issues.
China Monthly Report, September 1999. Produced and published by HSBC (Hong Kong and Shanghai Bank Corporation), China Services Limited, Hong Kong. China Economic Quarterly, third quarter, 1999. Produced in Beijing in cooperation with the Center for Economic Analysis and Forecasting (CEAF) at the Chinese Academy of Social Sciences (CASS), and published in Hong Kong.
The Economist, various recent issues.

[Author note]

JAMES DEAN is professor of economics, Simon Fraser University, Burnaby, BC, Canada, and Kaiser Professor of International Business, Western Washington University, Bellingham, WA. The author thanks the China Institute of Contemporary International Relations in Beijing, which arranged many helpful interviews during his visit in September 1999. He is also grateful to the Chinese Academy of Social Sciences, People's University in Beijing, Beijing University, and the Shanghai Academy of Social Sciences. This article benefited greatly from a reading of Lardy (1998), which is surely the definitive study of Chinese economic reform. For very helpful comments, he acknowledges Charles Adams of the International Capital Group at the International Monetary Fund, Margaret Cornish-Kehoe of Scotia Capital Markets, and Allan Sleeman. None of them is even remotely implicated by the argument of this essay.

[Author note]
